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TREASURY FOR INTERNATIONAL AFFAIRS - JROSE AND MNUGENT

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SUBJECT: IMF MISSION RUNS INTO ELECTION-YEAR RESISTANCE

Classified By: Economic Counselor Thomas Goldberger for reasons 1.4(b) and (d).

¶1. (C) Summary: The IMF mission currently in Turkey has run into a difficult negotiating stance on the part of a Turkish Government focused on the coming election year. With the IMF now expecting an 8% current account deficit in 2006 and slower growth and market volatility in the coming year, the Fund believes there is less room for mistakes and the Government needs to maintain fiscal austerity. This task is complicated by a combination of higher-than-programmed spending in 2006 using one-off revenues that will not be replicated in 2007. The mission chief recommends G-7 countries pass a message that the GOT needs to look beyond the November 2007 elections. The mission will either achieve a last-minute agreement in the next day or two or have to come back for further work. End Summary.

IMF View of the Economy:  
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¶2. (C) At a de-brief with G-7 Ambassadors hosted by Ambassador Wilson, IMF Mission Chief Lorenzo Giorgianni said growth was slowing as expected since the May-June jump in interest rates and fall in the exchange rate, but not as much as had been feared. The Fund now expects full-year 2006 GDP growth to come in around 6%, but expects a slowdown to a 5% rate in 2007, with risks to the downside. Fears of banking sector problems arising from asset-liability mismatches have not panned out, although local banks took some losses when interest rates spiked in June. The Fund is still "holding its breath" on the impact of the lira's depreciation on the corporate sector's substantial foreign exchange borrowing, but Giorgianni thought that if there would have been signs by now if the problem was serious.

¶3. (C) Giorgianni now expects the 2006 current account deficit to reach 8% of GDP, higher than most analysts are projecting and substantially higher than was thought a few months ago. In 2007, the deficit will ease only slightly to around 7.5% of GDP. Moreover, Foreign Direct Investment inflows are likely to be lower in 2007 than in 2006, increasing Turkey's reliance on (unreliable) short-term portfolio investment. 2006 inflation is expected to be about 10% and next year's 4% target will probably be breached with inflation in the high single digits. The Central Bank needs to manage the situation carefully, trying to head off a return of inflationary expectations.

¶4. (C) Giorgianni said the combination of strong growth, a large and growing current account deficit and stubbornly high inflation suggests there may be some overheating in the

economy. Moreover, the coming political season means there will be "noise" that will rattle markets. When investors pull out of Emerging Markets, they tend to pull out of Turkey more than others, particularly because of its higher current account deficit. The IMF therefore believes the Government has much less room for mistakes than in the past and that a fiscal policy lever needs to reinforce monetary policy.

#### Tough Negotiations over Fiscal Policy:

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15. (C) The IMF team is finding negotiations much more difficult than the last time they came, with the ministerial level clearly feeling political pressure to use government spending in ways that are helpful to the Government's reelection campaign. Though senior bureaucrats like Treasury U/S Canakci understood the IMF's arguments, they were clearly caught between the political pressures and policy orthodoxy. Finance Minister Unakitan told the Ambassador October 18 (septel) he had reached agreement with the Fund, and the Government submitted its 2007 budget to Parliament October 17, but Giorgianni said the Mission still has not reached agreement with the Government.

16. (C) Giorgianni and IMF Resrep Bredenkamp explained why achieving the 2007 6.5% primary surplus target has turned out to be very difficult: First, the Government enjoyed several one-off windfalls in 2006 that add up to an extra 1% of GDP. These include tax collections from the sale of assets formerly owned by the Uzan group, payments on GSM license fees, and payments under an amnesty/restructuring for people in arrears on their payments to the social security system. Not only would the Government not have these sources of funds in 2007, but they had gone ahead and spent the money in 2006 on current expenditure, creating a higher level as a basis for current spending in 2007.

17. (C) IMF officials claimed that the Government's recent decision on a salary increase for civil servants in 2007 was much more generous than generally believed. By IMF calculations it implies an increase in the government wage bill of 11% in real terms, thereby greatly reducing the availability of funds for other budgetary items. Bredenkamp pointed out that this generosity sends a signal to the private sector that the Government is not confident in the inflation targets, possibly encouraging private sector wage hikes. Agriculture and health spending hikes put additional pressure on the budget, squeezing investment and other non-current spending.

18. (C) Giorgianni stressed the challenge of not merely passing a good budget but of effectively implementing it. For 2006, he confirmed Turkish Ministers' recent statements that the 2006 primary surplus may end up at 7% or slightly above, but Giorgianni attributed this to the one-off receipts. Giorgianni had not detected any particular pressures to increase military spending. On the revenue side, where the budget anticipates large increases in revenues, Giorgianni told us he would be very uncomfortable confirming Unakitan's public pledge that taxes will not be increased.

#### Look Past Elections:

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9.(C) The mission plans to leave October 20, but they are starting to get pressure from the Government to extend their stay, despite the imminent end-of-Ramadan holiday. Giorgianni was unsure whether the Government would sign on to a last-minute agreement -- as they have with past missions -- or leave things unresolved such that the IMF would have to return. If there is a deal, Giorgianni expected that the executive board would meet in mid-December if certain prior actions are met. Also, the staff would have to recommend -- and the board approve -- a waiver for exceeding the 2007 spending caps agreed to in the July Letter of Intent.

10. (C) When the Ambassador asked what messages the IMF

recommended that G-7 officials pass to Turkish counterparts, Giorgianni suggested the Turkish leaders need to look past November 2007. Giorgianni and Bredenkamp pointed out that by thinking about and communicating their post-election vision, rather than merely reacting to short-term IMF and EU requirements, the Government could give confidence to potential direct investors. The politicians need to avoid the temptations of VAT rate cuts for particular sectors or other populist actions that will make it that much harder to meet targets or to reassure investors.

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